



FRONTEO

TYO: 2158

Market Cap

JPY 52,186 million

Last Close

JPY 1,331

(As of July 9, 2021)

In this article, we would like to sort out the questions and expectations of investors. Hopefully these may help investors when they have a think on the shares. Please refer to other materials for details of the business. The video presentation by President Morimoto is recommended. Also, there are plenty of charts and data in the handout of his briefing session.

It should be easier to understand the company if you keep in mind that there are three major revenue streams. These are Life Science AI, Business Intelligence and Legal Tech. The company calls the former two AI Solution. And it divides Life Science AI into AI diagnosis and drug discovery, and Legal Tech into Legal Tech AI using KIBIT and conventional business to disclose sales in detail.

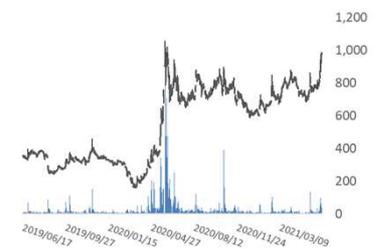
Conclusion

Fronteo's stock price has risen nearly six times in three months during early 2020, gaining the impressively high price multiples of bioscience stocks and is highly valued in the stock market. Management's goal is to achieve sales of 30 billion yen and operating income of 6 billion yen in what they call a Stage 4 by driving AI Solution. However, it is not clear when that is. In FY March 2021, sales were 10.5 billion yen and operating income was 500 million yen. BPS registered 114 yen and ROE marked a nice 9.5%. Currently market capitalization is about 40 billion yen. If the company's long-term goals are achieved and the stock price is valued at a PER of 20 times at that time, the market capitalization should be a little over 70 billion yen. Stage 3 took 6 years. Assuming that Stage 4 is also six years away, the target will be achieved in the FY March 2027. As a very rough estimate, assuming that PBR will not change and the stock price will only reflect the growth of BPS, the market capitalization will double if ROE is maintained at 11%. If PBR is derated to 5x, ROE must be over 20%. It is felt that there is still a lack of information for institutional investors to anticipate a bright medium- to long-term that gives some degree of confidence to think about a position in their funds. However, the stock of Fronteo does present a possibility of an opportunity to earn attractive investment returns over the long term.

Industry

Service

Price performance



YH (21/06/25) ¥1,168

YL (21/01/18) ¥595

25-day moving ave. ¥803

75-day moving ave. ¥778

IR Contact

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Company website

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Period	Revenue (mn, yen)	EBITDA (mn, yen)	EPS (yen)	PER (CE) (X)	PBR (X)	ROE (%)
3/18	12,218	1,369	-22	0.0	8.9	0.0
3/19	11,262	1,216	1	1,489.5	4.7	1.2
3/20	10,471	0	-24	0.0	2.5	0.0
3/21	10,370	1,469	9	3,191.5	7.1	9.5

Thoughts on the long term

Recently, President Morimoto has been passionately telling investors that business expansion will progress by converting Fronteo to a company-wide AI business and expanding solution businesses. In a nutshell, the core business will shift from the traditional labor-intensive Legal Tech to the AI business. The results are already visible in the business results.

According to President Morimoto, each of the three businesses in Stage 4 will have sales of 10 billion yen. Life Science will have an OPM margin of 30% and an OP of 3 billion yen, Business Intelligence will have an OP margin of 20% to generate OP of 2 billion yen, and Legal Tech will carry an OP margin of 10% and produce OP of 1 billion yen. In total Fronteo will achieve an OP margin of 20% on sales of 30 billion yen and OP will be 6 billion yen for the entire company. The driver of Life Science business will be medical devices to be covered by national healthcare insurance, which will lead to explosive sales growth. Business Intelligence will see the number of customers double from the current 200 companies to 400, while sales per company will rise threefold. To this end, the company will raise the unit price while increasing the number of products. As well as sales, Legal Tech will see its OP margin increase by bringing the proportion of AI products from the current 19% to 100%.

Based on the company materials, we tried to quantify the long-term market size and the sales of the company. It should actually be a non-linear development as. The numbers are simple productions by multiplying with the growth rate calculated back from the stage 4 goal. At a glance, the market expansion of AI Solution is attractive, growing at an annual rate of 24%, whilst Fronteo needs more than 40% growth in AI Solution to achieve its FY2026 target. Life Science requires a growth rate of 50%. These should be very high hurdles. On the other hand, Legal Tech's 10 billion yen target looks fairly conservative.

Revenue Simulation for Fronteo (2158)

(FY2015~FY2021)

(million yen)

FY	2015	2016	2017	2018	2019	2020 A	2021 Co
AI Solution	120	311	910	1,427	1,353	2,124	2,560
Life Science						461	860
Business Intelligence						1,662	1,700
Legal Tech	10,433	10,896	11,307	9,865	9,117	8,245	7,940
Legal Tech AI					1,170	1,547	2,500
Non-AI					7,947	6,698	5,440
Total Sales	10,553	11,207	12,217	11,292	10,470	10,370	10,500

(FY2022~FY2027)

FY	2022	2023	2024	2025	2026	2027	6YR CAGR %
AI Solution	3,578	5,017	7,056	9,954	14,087	20,000	41
Life Science	1,294	1,948	2,933	4,414	6,644	10,000	51
Business Intelligence	2,284	3,069	4,123	5,540	7,443	10,000	34
Legal Tech	8,251	8,575	8,911	9,260	9,623	10,000	4
Legal Tech AI							
Non-AI							
Total Sales	11,830	13,592	15,966	19,214	23,710	30,000	19

Market Size Forecast

(2019~2023)

(100mn US dollar)

	Sub-segment	Region	2019	2020	2021	2022	2023
AI Solution			223	262	310	372	451
Life Science			147	176	213	262	328
	AI Diagnosis	Global	36	52	75	108	156
	Drug Discovery	Global	111	124	138	154	172
Business Intelligence	Digital Transformation	Japan	76	86	97	109	123
Legal Tech	eDiscovery	Global	112	127	143	161	182

(2024~2027)

	Sub-segment	Region	2024	2025	2026	2027	6YR CAGR %
AI Solution			556	694	881	1,135	24
Life Science			416	537	703	934	28
	AI Diagnosis	Global	224	323	464	668	44
	Drug Discovery	Global	192	214	239	266	12
Business Intelligence	Digital Transformation	Japan	139	158	178	201	13
Legal Tech	eDiscovery	Global	206	233	263	297	13

Fronteo Market Share

	2020	2021	2022	2023	2024	2025	2026	2027
Life Science	0.02%	0.04%	0.04%	0.05%	0.06%	0.07%	0.09%	0.10%
Business Intelligence	0.18%	0.16%	0.19%	0.23%	0.27%	0.32%	0.38%	0.45%

OP by Segment

(million yen)

	2016	2017	2018	2019	2020	2021 Co
AI Solution	-715	-282	97	-178	286	360
Legal Tech	-491	460	119	-665	220	240
Total OP	-1,206	177	216	-844	507	600

Source: Omega Investment by company materials

All estimates by Omega Investment, except FY2021 company guidance. Based on JPY110/USD.



Sales of AI Solution have increased remarkably since the FY March 2018, accounting for 13% of the sales in FY2020. Operating income posted a surplus rising from the deficit of the previous year, and registered an OP margin of 13%, which proved to be an alarming improvement. Of more importance to investors is the record that the combined sales of the AI Solution and the AI projects utilising KBIT within the Legal Tech segment have increased by more than 40% year-on-year, and commanded 36% of the consolidated sales. We feel it a little strange that the President does not emphasise this index so much in his presentation, as it is considered to be a major factor in considering the stock investment.

Previously, investors felt that Legal Tech, which is the core business of Fronteo, has been sluggish in recent years due to the severe operating environment, and although there may be growth thanks to AI, they thought that overall, the company is fragile and its long-term cannot be viewed optimistically. Their view was that even though Legal Tech will generate profit, no growth opportunity is found. Currently the company is expanding sales of its own AI solution called KIBIT Automator, and the legal business is also a strategy to increase the AI ratio and grow both sales and profit. This is also becoming more evident in business results. By the way, the report of the third-party committee submitted on June 10, 2021 regarding the corporate governance of Toshiba (6502) was made by three lawyers, who adopted Fronteo's AI analysis method and conducted a forensic surgery of 520,000 emails and 250,000 documents attached to them.

KBIT is an AI developed by Fronteo in its Legal Tech business and was launched in November 2015. Roughly speaking, the business that applies this AI to other fields is the AI Solution, so KBIT can be regarded as the foundation of the company's AI technology. Life Science AI for medical and drug discovery, and Business Intelligence for financial and manufacturing industries are operated using the AI technologies. The characteristic of the company's AI is that it specializes in languages. In addition, it requires only a small amount of teacher data and a small amount of computer power and is highly accurate. At Legal Tech, there is a step to process a large amount of documents, and the cost of lawyers is prohibitively high. If one uses KIBIT, one can just teach the document as it is, and KIBIT captures the sequence and characteristics of words and analyzes it with a small amount of teacher data.

Bulls

- Fronteo is a technology innovation and is expected to grow over a long time. Considering the future growth of the DX market, it should be highly resistant to recession and will not be affected by the economic cycles. The language-based AI engine is an in-house developed technology, and there should be plenty of opportunities for development and diversion, which will add to the top-line sales expansion. It is particularly interesting that language-based AI medical devices in the Life Sciences business have the potential to explode sales once they are approved for inclusion in the list of national insurance coverage.
- Currently the AI solution business is running strong. Life Science has received orders from major pharmaceutical manufacturers, and pipeline development seems to be proceeding well. Business Intelligence service is in good favour, especially amongst financial companies. It seems to be being introduced well by the manufacturing industry as well. The strength is being backed by corporate digital investment for regulatory compliance and the desire to improve efficiency, which should be sustained over the long-term.



- At Legal Tech, orders for projects that utilize the AI review tool KIBIT Automator are steadily increasing, and the AI conversion of this business segment is progressing. So far, the profit margin of projects using KIBIT Automator is superior to that of conventional reviews. The management's Legal Tech business's sales growth forecast is modest, and it seems realistic that they achieve sales of 10 billion yen by continuing to promote AI in a market where growth has become difficult.
- It is interesting that the company started an information analysis solution business in the field of economic security. It is an era in which not only civilian technology but also vaccines may be diverted to military use, and the growing interest in economic security in the political and business world is the driver. By collecting and analyzing publicly disclosed information, this solution system will visualize the connections between companies, shareholders, and researchers, grasp the complex world situation, and contribute to the planning and execution of economic and security strategies. Management has identified this year as the first year of the business and reports that inquiries are booming.

Bears

- The period of Stage 4 is unknown, and it is difficult to calculate the fair value of the shares. It is difficult to have a view as to whether or not it is possible to achieve an average annual sales growth of nearly 20%, even assuming Stage 4 is 6 years out. Business Intelligence is doing well, but one is not sure if Life Science, which is one of the cornerstones of growth, will grow at an annual rate of 50%. The hunch is that the management's targets are a little too high a hurdle. In addition, it is difficult to measure how realistic the management's profit margins for Stage 4 are.
- The passionate president should not be understated, as he may be signaling a particularly interesting stage in the life cycle of his company. However, it is difficult to determine the appropriate stock price without various assumptions and management's guidance. It is difficult for investors to guess what the fantastic horizon is, if only the president can see it, from the information obtained from public sources.
- The market potential is great, but Fronteo will remain a very small player. According to a simple calculation based on what the company gives out, even if Fronteo achieves sales of 30 billion yen in 2027, its market share will be only 0.10% in the global life science market and 0.45% in the domestic digital transformation market. In other words, there are many competitors in the market, and it will be a fierce environment in which they compete fiercely. The company's AI being a self-developed technology, it should be well accepted in the market for the time being, but what is the risk of competition and future technology substitution? Investors should carefully forecast Fronteo at this stage.
- The secular profit margin of AI Solution is difficult to predict. There is no medium- to long-term guidance by the company other than the Stage 4 goals. Investment for product development should be necessary, but it has not been discussed. Also, it is difficult to have a view on the possibility of finance that may dilute the per share value. Management has not touched on what degree of milestone ROE they will look at a stage when business has become reasonably good before achieving Stage 4 targets. Investors are afraid that the management may be forgetting what is thought to be the most important numeric for investors.



- The management's guidance for FY March 2022 is lacklustre. It may be made conservative, but it makes investors feel that it is too early to predict an interesting earnings leap forward.

Shareholding situation

Institutional investors have sold their positions following the soaring stock prices since last year, and two large individual investors have sold their stakes in a total of just under 230,000 shares. After that, only a few institutional investors made a few purchases, and institutional investors generally find it difficult to start a position given expensive valuations after the stock price surge. Except insiders, it is presumed that most of the shares are held by individuals. So, for the time being, stock prices are likely to be influenced by short-term news flows. There should be many investors who want to deepen their understanding of the company so that they can buy the shares quickly if the stock price falls in a timely manner or when exciting positive news comes out. It seems that there are few foreign shareholders. According to the Shikiho, the foreign ownership ratio was 12.5% in March 2018, but it was 1.98% as of March 2021. It was 1.2% in March of the last year, and has increased slightly.

The current shareholder composition of the company is 1.2% by institutional investors and 36.4% by insiders, of which 25.1% are individuals including President Morimoto, and of the listed companies, i.e., Focus Systems (4662) and Gakken Holdings (9470). The two listed companies hold a total equity of 10.3% and other than these there are very small holdings of private companies and employee stock ownership. It is estimated that the remaining 62.4% is mostly owned by individuals. The free-float ratio is 63.5%, of which 1.9% is held by institutional equity.

During the six months since the beginning of 2021, the top institutional investors sold their shares, resulting in a 1.2% stake in institutional investors, which exceeded 10% in FY3/2019. One large company sold all the 1.8 million shares and the other significantly reduced its position. Mr. Shiraishi and Mr. Nozaki, who were the top two non-management individual shareholders, sold all the 110,000 and 117,000 shares, respectively. The only institutional buyer after the stock price surge is a Japanese asset management company, which bought 205,000 shares during the last year and currently accounts for less than half of the institutional stake as a 0.52% shareholder. In December 2008, there was a third-party offering of new shares, and Focus Systems (4662) and Gakken Holdings (9470), which had been shareholders for some time, acquired a total of 1.04 million shares at a price of 766 yen. Prior to that, the new shares were issued in September 2014, and the Deutsche Bank London branch acquired 1 million shares for 1,155 yen. The impression is that funding in the stock market was fairly inactive.



Business

- Legal Tech: Services such as discovery support for companies facing litigation mainly in the United States. The ratio of AI products within this segment is increasing thanks to sales expansion of KIBIT Automator.
- Life science AI: Divided into AI diagnosis, AI drug discovery, and AI prediction system. For AI diagnosis, the company develops an AI system to support dementia diagnosis. If approved by the pharmaceutical regulatory affairs, it will be the world's first launch of AI medical devices for language-based AI. There is a possibility that AI medical devices are developed for other mental illnesses. Drug Discovery utilizes natural language AI technology to provide Amanogawa, or a treatise search AI, and Cascade-Eye, which is a drug discovery support AI. These reduce the enormous cost of new drug development and the burden of long-term research and development. The AI prediction system offers the in-house developed fall prediction system "Coroban®". AI analysis of nursing records predicts the risk of falls of elderly patients and reduces the burden of hospital staff.
- Business Intelligence: Utilizing the AI technology cultivated in the Legal Tech business, the company provides solutions that help improve work efficiency in various business fields such as human resources, intellectual property, legal affairs, and labor.

Source: Made by Omega Investment from various materials.

Omega investment view - Definition

An insight into intrinsic value of the business and the stock price, and a presentation of investment views or perspectives that contribute to intelligent investment decisions. Stock recommendations are not the purpose. Contrarian views and non-consensus ideas are valued.

Investment ideas are put into the portfolio managers' context, taking into account the broader picture of the financial market and the economic environment, as well as the primary clients of institutional investors such as pension, wealth management, family offices and holders of investment trust, etc. Investment views are produced by digesting various data, company materials, analyst reports, and other easily available materials. One-on-one interviews may be held if deemed appropriate.

Rich in subjective discussion and de-emphasizes detailed explanation of the business. Equity investment strategies vary widely, therefore stocks are not graded. However, in most Omega Investment Views readers should easily see what the sensible investment action is. In case of excellent alpha expectation, we would not hesitate to express strong opinions.